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ABSTRACT

This testimony before the House Subcommittee on Postsecondary Education addresses the need for improving student financial aid programs administered by the Department of Education, and in particular, the Stafford Student Loan Programs. The testimony begins with a brief review of the default problems involving student loans. Next, an examination is provided of the Congressional, Department of Education, and General Accounting Office efforts in addressing student loan defaults. The improvements needed to correct vulnerabilities in the Stafford Program are addressed, followed by a discussion of the procedures for determining school eligibility that put the Government and the student at risk. Next, several recommendations are presented for solving or lessening the occurrence of default problems in student loan programs. It is noted in the testimony that many of the vulnerabilities and weaknesses in federal student aid programs are related to the Department of Education's administration of the programs, as well as to provisions of the Higher Education Act. An attachment provides a list of selected General Accounting Office reports on higher education issues since 1986. (GLR)

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Vulnerabilities in the Stafford Student Loan Program

Statement of
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for Human Resources Programs

Before the
Subcommittee on Postsecondary Education
Committee on Education and Labor
House of Representatives

GAO/T-HRD-91-33

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Mr. Chairman and Members of the Subcommittee:

I am here today to share our views about some ways to further improve student financial aid programs administered by the Department of Education. These programs are extremely important to students seeking a postsecondary education and to the future workforce of our nation. In recent years these programs have been the subject of great scrutiny--much of it focused on student-borrowers who have defaulted in the Stafford Student Loan Program.

STAFFORD PROGRAM PERSPECTIVE

As you know, loan default costs have been growing--from $1.3 billion in 1986 to $2.5 billion in 1990--and have become an ever increasing portion of the government's cost in operating the Stafford program.

Defaults have risen from about 10 percent of total program costs in fiscal year 1980, to 44 percent in 1990.[1] In comparison, interest subsidies have decreased to about 52 percent of the program's costs in 1990.[2]

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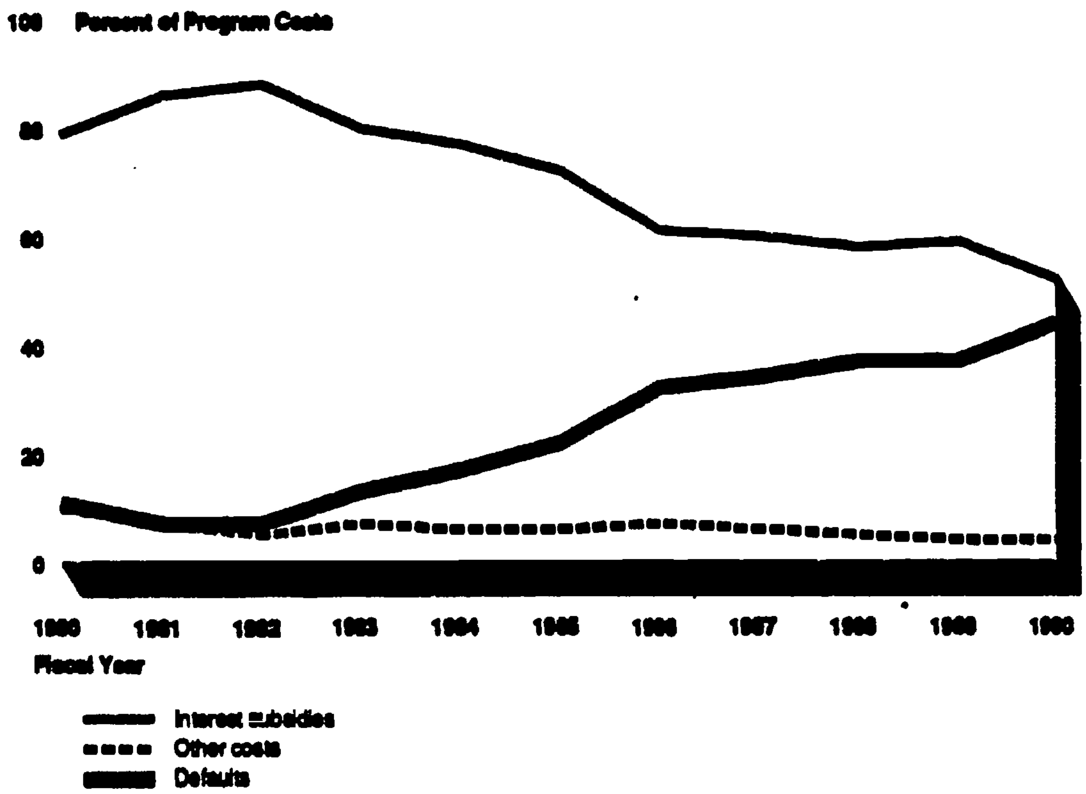
[1]The default costs represent reinsurance paid to guaranty agencies.

[2]In part, the declining interest subsidy stems from declining Treasury bill rates used to compute the size of the subsidy.

Figure 1: Defaults As a Percentage of Program Costs



CONGRESSIONAL, DEPARTMENTAL, AND GAO EFFORTS ADDRESSING LOAN DEFAULTS

The loan default problem has not been ignored. The Congress and the Department have implemented many changes during the past several years to address the default issue. For example, the Congress enacted 18 pieces of legislation since 1980 that had one or more provisions related to student loan defaults or default collections, and most of this legislation has occurred since the last reauthorization.

The Department has also taken several steps designed to improve the integrity of the Stafford program. For example, in its fiscal year 1992 budget request, the Department proposed over 30

legislative changes to the program. These proposals include default prevention, default collections, and risk-sharing measures.

In early 1991, the Department and the Office of Management and Budget completed a joint study of the Department's Office of Postsecondary Education. The resulting report found that the Department's management practices contribute to high loan default rates and, more generally, to fraud and abuse in student aid programs. The report contains many recommendations that, if implemented, would result in a major restructuring of the office to better administer and oversee student financial aid programs.

The Comptroller General has identified the guaranteed student loan programs as 1 of 16 federal programs where internal and management control breakdowns are placing the federal government at risk. GAO has issued over 30 reports on higher education topics since the last reauthorization of the Higher Education Act in 1986, and most of these products have concentrated on student loans.[3] We have made numerous recommendations to the Congress and the Department for improvements, and are pleased that many of them have been implemented.

MORE IMPROVEMENTS NEEDED TO CORRECT VULNERABILITIES IN THE STAFFORD PROGRAM

We support efforts by the Congress and Department to address many of the problems that have been identified. We also support many of the Department's current legislative and programmatic proposals which should strengthen the financial management of, as well as restore confidence in, federal student aid programs.

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[3]A list of these products is attached.

However, we believe further efforts are needed. To better ensure that eligible students are completing their school experience and repaying their student loans, additional changes must be made to the structure and administration of the Stafford program. In particular, the Department needs to:

-- do a better job of approving and monitoring the schools that are allowed to participate in the programs, and

-- assure that data systems are created that will screen out ineligible students before they receive guaranteed loans.

And working together, the Department and the Congress need to:

-- provide better incentives for lenders and guaranty agencies to assume part of the responsibilities for preventing defaults, and

-- require guaranty agencies to maintain adequate reserves and avoid potential conflicts of interest to better ensure their financial stability.

Changes such as these could reduce access somewhat, in particular to students enrolling in certain vocational and trade schools. On balance, we believe this risk is an acceptable price to pay for assuring the financial integrity of the student aid programs. But the Congress and the administration will have to be sensitive to minimizing any obvious adverse consequences as reforms are implemented.

I would like to discuss six key areas which relate to these potential changes for further improving program integrity. These areas are shown in figure 2. They focus primarily on developing ways to strengthen the front end of the loan process by increasing

default prevention efforts, rather than improving post default activities.

Figure 2: Areas for Further Improving Program Integrity

- Approving schools
- Reducing borrower abuse
- Increasing lenders' risk
- Preventing conflicts of interest
- Focusing on default prevention
- Setting reserve requirements

Procedures for Determining School Eligibility Put the Government and Students at Risk

The Department should establish better standards and guidelines for screening schools that want to participate in student financial aid programs. These criteria could consist of outcome measurements such as student completion and placement rates. The Department also needs to establish a better system for monitoring schools that currently participate.

Many student-borrowers have attended schools that have not provided them with a quality education; some seem to exist primarily to take advantage of the "cash cow" provided by the government. Students attending such schools suffer at least two consequences: (1) they receive little or no training, and (2) they incur student loan debt they cannot repay because they lack the skills needed to become gainfully employed. Such schools also expose students and the federal government unnecessarily to risk of financial loss.

The Department's process for approving schools is not effective in identifying these schools. The process relies heavily on actions taken by organizations such as state licensing agencies and private

accrediting agencies. Unfortunately, experience shows that these organizations have their own goals and objectives, and do not necessarily act in the government's interest.

The Department, however, is the ultimate gatekeeper of federal student aid programs. As such, it needs to play a more active role in screening schools to reduce the exposure to financial risk to the government and students. In approving schools initially and monitoring schools currently participating, it should ensure that schools are financially sound and administratively capable of providing the education that they advertise. To assist the Department in playing a more active gatekeeper role, we are currently examining the standards or guidelines that could be developed and used by the Department to evaluate schools more closely.

Department's Loan Data Base Not Fully Used In Preventing Borrowers' Abuses

The Department should expedite the development of its new student loan data system to more effectively protect the integrity of the Stafford program. This system is crucial in providing departmental officials part of the information they need to prevent student-borrowers from abuses such as (1) exceeding statutory loan limits and (2) receiving additional loans when they are already in default.

The Department's current student loan data base has not been effective in providing information which could be used to prevent student borrowers from abusing the loan program. Abuses have occurred, in part, because the data base was not designed to help guaranty agencies and their lenders verify borrower eligibility.

In 1986, the Congress provided the Department the authority to develop the National Student Loan Data System. Such a system could be used to assist lenders and guaranty agencies in guarding against borrower abuse. However, until 1989 the Congress prohibited the use of this system to verify borrower eligibility before loan approval.

The administration was reluctant to fund the design of the new system until the restriction was lifted. The Department now plans to complete development of the system in late 1993. We hope the Department meets its deadline.

Lenders Have Little Incentive to Prevent Defaults

Alternatives should be developed that would encourage more default prevention efforts by lenders. Such changes would encourage lenders to pay more attention to the kinds of schools their borrowers attend and the repayment practices of students.

Lenders generally incur very little financial risk for borrowers who default on their loans as long as lenders adhere to the Department's collection procedures. These procedures--called "due diligence"--set specific time frames for lenders to initiate telephone calls and send letters to students who are delinquent on their loans.

The collection requirements, in many cases, can be a pro forma process because the telephone calls and letters may be easily recorded by computer software. When a lender submits its default claim documenting that due diligence was performed, it receives 100 percent of the principal amount and accrued interest on the loan. Therefore, lenders are subject to very little risk in making student loans.

The Department has proposed two legislative changes in its fiscal year 1992 budget request that would require lenders to assume more accountability and risk for the loans they make. These proposals would

-- Require that lenders provide borrowers with graduated repayment options. This would permit borrowers, for example, to pay only interest during their first 4 years of loan repayment and defer loan principal repayments during that period.

-- Reduce lenders' special allowance (interest subsidy) payments by 0.25 percent if they have default rates of 20 percent or more during a fiscal year.

We believe that the Department's proposal has merit, and parallels our previously reported concerns that lenders have little to lose when their guaranteed loans default. The Department's proposals are directed toward getting more accountability for lenders with high default rates. Our previous suggestion, although different from the Department's, would have lenders receiving less than a 100 percent guarantee on their loans so that they would share in the risk of their defaulted loans.

<u>Guaranteed Student Loan Operations Subject to Conflict of Interests</u>

The Department should develop standards of conduct and requirements for separation of duties among guaranty agencies, lenders, and loan servicing organizations. These are needed to avoid potential losses from conflict of interests, as well as to improve the credibility and integrity of the Stafford program. The Department asked the Congress for the authority to issue such standards in its 1992 budget request. We encourage the Congress to give the Department this authority.

Guaranty agencies' activities and their relationships with lenders and loan servicers have resulted in less than arms length transactions, raising various questions about possible conflict of interest. Guaranty agencies perform a major function as the middleman in the Stafford program. They are supposed to ensure that lenders have properly pursued loans for collection before they file default claims.

However, some guaranty agencies also operate their own loan servicing operations. In such arrangements, the agencies can be in the position of being both the guarantor and lender for the same loan. Should such a loan go into default, the agencies must determine whether the correct loan collection procedures were followed. Quite obviously, in these instances, the agencies have a conflict of interests, since they are evaluating their own loan servicing activities. Therefore, we believe that guaranty agencies should be prevented from servicing loans that they guarantee to avoid possible unnecessary risks with apparent conflict of interests.

Guaranty Agencies Lack Incentives to Prevent Defaults

Under current law, guaranty agencies have a financial incentive to allow delinquent borrowers to default. They typically receive 100 percent reinsurance for default claims paid to their lenders, and can then retain up to 35 percent of funds subsequently collected from defaulted borrowers. We believe that the provision allowing guaranty agencies to keep up to 35 percent of default collections should be repealed in order to remove this incentive.

Instead the collection responsibility would be shifted to the Department. The shift will allow the federal government to keep all of the proceeds. Also, it should enhance collections because the Department possesses more collection tools than the agencies in

trying to convince borrowers to repay, such as IRS income tax refund offsets and federal employee wage garnishments.

In addition, the program should be restructured to provide financial incentives that encourage more guaranty agency default prevention activities. Although guaranty agencies incur some costs when defaults reach certain thresholds, they are financially rewarded primarily after delinquent loans default and defaulted borrowers subsequently make payments on their loans. Instead agencies should be rewarded more for keeping delinquent borrowers from defaulting. Albeit the agencies' have a primary function of assisting lenders in preventing defaults--agencies have several chances at default prevention--they are given little reward if they are successful.

No Requirements for Guaranty Agencies to Maintain Reserve Levels

The Department should establish minimum reserve levels for guaranty agencies. Under present statutory requirements, the Department is not liable for paying lenders' claims on defaulted loans when guaranty agencies become insolvent. However, the statute authorizes the Department to take various legal actions, including the payment of claims. The Department has insured the payment of lenders' claims in the one instance when a guaranty agency did fail--the Higher Education Assistance Foundation (HEAF) which failed in 1990. The Department may incur more than the $30 million in costs as a result of the agreements reached to resolve the failure of HEAF. As a practical matter, this is likely to happen again if other agencies get into financial trouble.

No federal requirements exist for financial reserve levels that guaranty agencies should maintain, potentially increasing federal exposure to program losses. Failure to have such requirements contributed to the HEAF's collapse. In its 1992 budget request,

the Department has proposed that the Congress give it the authority to require certain minimum reserve levels for guaranty agencies, as well as allowing it to terminate its agreement with a guaranty agency if the reserve level is too low. We support this proposal.

CONCLUSIONS

Stafford loans give eligible students access to low-cost loans to further their postsecondary education. The Department of Education is responsible for administrating the program to ensure congressional objectives are being attained as well as protecting the federal government from any undue financial risks or vulnerabilities. As such, the Department must ensure that (1) participating schools provide an education that leads to gainful employment, (2) only eligible students be given federal aid, and (3) the lenders and guaranty agencies share more in the risks associated with the program.

Many of the vulnerabilities in the federal student aid programs, including those we discussed today, put the government at risk. Some of these weaknesses are related to the Department of Education's administration of the programs, others can be traced to provisions of the Higher Education Act. The administration is proposing a series of legislative changes that, if enacted, should address many of the program's shortcomings.

We believe that our recommendations and suggestions will provide the Congress and the Department the impetus for correcting many of the deficiencies in the Stafford program, and lead to more efficient and effective delivery of loans to eligible students.

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Mr. Chairman, that concludes my statement. I would be happy to answer any questions that you or the other Subcommittee Members may have.

SELECTED GAO REPORTS ON HIGHER EDUCATION ISSUES (SINCE 1986)

Student Loans: Characteristics of Defaulted Borrowers in the Stafford Student Loan Program (GAO/HRD-91-82BR, Apr. 26, 1991).

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Defaulted Student Loans. Private Lender Collection Efforts Often Inadequate (GAO/HRD-87-48, Aug. 20, 1987).

<u>Student Aid: Financial Assistance to Scholarship Athletes</u> (GAO/HRD-87-78BR, May 11, 1987).

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